

Tencent (700 HK)

China / Internet / Result Snapshot

Target price: HK\$160.0
Previous TP: HK\$160.0
Last price: HK\$135.9
Potential Return: 17.7%

Internet giant continues to grow

- 41%/50%/75% 4Q growth for online game/ social network/ online advertising
- Fastening mobile monetization
- Peaking opex ratio

Maintain BUY

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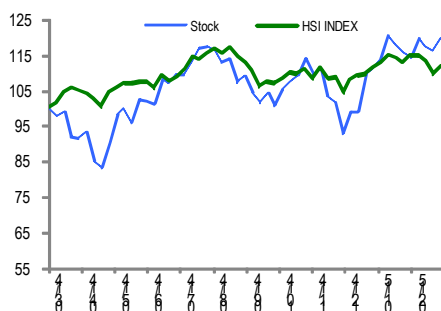
Forecast revision (%)

Year to 31 Dec	14F	15F	16F
Revenue change	N.A.	N.A.	N.A.
Net profit change	N.A.	N.A.	N.A.
EPS change	N.A.	N.A.	N.A.

Key Share Data

52-week High / Low	HK\$ 138 / 93
30D avg volume	15.44 Mn
Issued share	9,373.22 Mn
Market cap	1,273,820Mn
Major Shareholder	MIH (33.62%)

Share Price Performance



Key Financials

Year to 31 Dec	2013	2014F	2015F	2016F
Turnover (RMB m)	60,437	76,137	90,093	111,046
Growth (%)	38	26	18	23
Net Profit (RMB m)	15,502	23,785	30,351	38,380
Growth (%)	22	53	28	26
EPS (RMB)	1.692	2.577	3.239	4.092
Growth (%)	21	52	26	26
PER (x)	63.7	41.9	33.5	26.5
P/B (x)	17.1	12.2	9.2	7.0
DPS (HK\$)	0.240	0.357	0.449	0.567
Yield (%)	0.2	0.3	0.3	0.4

Source: Core Pacific - Yamaichi estimates

What's New

Tencent reported 50%/54% increase in 4Q14/FY14 net profit to RMB5,860 mn/ RMB23,810 mn. Excluding disposal gains, the 4Q14/FY14 growth were 57%/44% to RMB5,517 mn/ RMB21,051 mn respectively.

Our View

Strong growth across major business lines. Online game/ social network/ online advertising reported 41%/50%/75% yoy growth in 4Q14, compared with 34%/47%/76% growth in 3Q14. (Even excluding the rebooking of mobile game, 4Q growth of online game and social network were still at respectable 39%/48%) In particular, (i) Thanks to Tencent's strong mobile franchise, mobile game revenue picked up to RMB3.8 bn in 4Q14 from RMB2.6 bn in 3Q, (ii) Mobile monetization is taking place, as performance based social advertising was ramping up in Mobile Qzone and WeChat.

Improving profitability. (i) Online game and social network registered 3.4 pts yoy decline in gross margin because of increase mobile game contributions, (ii) Though online advertising reported 11.8 pts qoq gross margin contraction, this was attributed to seasonal factor and the 7.5pts yoy gross margin expansion was still satisfactory, (iii) Selling and marketing expenses ratio declined, because of quitting E commerce business and reducing WeChat overseas promotion, (iv) Admin expenses ratio stayed high because of R&D commitment, (v) Core operating and net margin (excluding disposal related gain) in 4Q14 showed 8.1 pts/5.6 pts yoy expansion respectively. More importantly, the rate of improvement had fastened compared with previous quarters.

Still strong organic growth. We think the slight shortfall in reported bottom line was attributed to higher than expected effective tax rate and associated loss in JD.com (Associates loss increased to RMB275 mn in 4Q14). The 66%/57% core EBIT/ net profit yoy growth in 4Q14 were encouraging and showed a fastening trend compared with previous quarters.

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I, Luo Jing, a licence holder of Type 4 Regulated Activity registered with the Hong Kong Securities and Futures Commission ("SFC") and a member of the research team that has prepared this research report, hereby declare that she currently holds shares of Tencent (700 HK).

Table 1: Tencent 4Q14 and FY14 results summary (RMB mn)

RMB mn	4Q13	4Q14	YoY%	FY13	FY14	YoY%	Comments
Revenue	16,970	20,978	23.6%	60,437	78,932	30.6%	
On-line game	8,475	11,964	41.2%	31,965	44,756	40.0%	Fastened momentum in 4Q14. Mobile games picked up and recorded RMB3.8 bn 4Q14 revenue. Desktop games recorded single digit growth. Even excluding re-booking of mobile game into principle based, segment growth still at respectable 39%
Social network	3,457	5,173	49.6%	13,020	18,554	42.5%	Fastened momentum in 4Q14, as driven by higher in-game item sales within mobile platform and increased subscription revenue
Online advertising	1,497	2,627	75.5%	5,034	8,308	65.0%	Maintained momentum in 4Q14, as driven by performance based social advertising in mobile platform, and video advertising
E commerce	3,324	446	-86.6%	9,796	4,753	-51.5%	Transferring e commerce business to JD.com, repositioning Yixun into market place operations
Others	217	768	254%	622	2,561	312%	
Gross profit	8,772	12,646	44.2%	32,659	48,059	47.2%	
Gross margin	51.7%	60.3%	8.6%	54.0%	60.9%	6.8%	Gross margin improvement was attributed to fading out E commerce business. However, online game gross margin registered 3.4 pts yoy decline in 4Q14 as a result of increased mobile games.
Reported:							
EBIT	4,374	6,951	58.9%	17,880	28,866	61.4%	(i) Selling and marketing expenses ratio declined, because of quitting E commerce business and reducing WeChat overseas promotion, (ii) Admin expenses ratio stayed high because of R&D commitment, (iii) Associates loss increased to RMB275 mn in 4Q14 because of JD.com and (iv) RMB343 mn disposal gain in 4Q14
EBIT margin	25.8%	33.1%	7.4%	29.6%	36.6%	7.0%	
Pre-tax profit	4,739	6,846	44.5%	19,281	29,013	50.5%	
Pre-tax margin	27.9%	32.6%	4.7%	31.9%	36.8%	4.9%	
Net profit	3,911	5,860	49.8%	15,502	23,810	53.6%	
Net margin	23.0%	27.9%	4.9%	25.6%	30.2%	4.5%	
Adjusted:*							
EBIT	3,969	6,608	66.5%	16,976	26,107	53.8%	Core operating performance was better than our expectation. The slight reported bottom line shortfall was partly attributable to associate loss in JD.com and higher than expected effective tax rate
EBIT margin	23.4%	31.5%	8.1%	28.1%	33.1%	5.0%	
Pre-tax profit	4,334	6,503	50.0%	18,378	26,254	42.9%	
Pre-tax margin	25.5%	31.0%	5.5%	30.4%	33.3%	2.9%	
Net profit	3,506	5,517	57.4%	14,599	21,051	44.2%	
Net margin	20.7%	26.3%	5.6%	24.2%	26.7%	2.5%	

* Mainly excluded disposal related gain

Source: Company and Core Pacific - Yamaichi

Profit & loss (Consolidated)					
Year to 31 Dec (RMB mn)	2012	2013	2014F	2015F	2016F
Revenue	43,894	60,437	76,137	90,093	111,046
Online game (old)	22,849	-	-	-	-
Internet community (old)	9,146	-	-	-	-
MVAS (old)	3,723	-	-	-	-
Online game (new)	-	31,966	43,995	53,674	63,335
Social network (new)	-	13,019	17,901	22,555	27,518
Online advertising	3,382	5,034	7,551	10,798	15,441
E commerce	4,428	9,796	4,500	-	-
Others	365	622	2,190	3,066	4,752
Gross profit	25,686	32,659	46,729	58,837	72,219
Other income, net	(284)	904	2,500	350	350
Operating expenses	(10,759)	(15,683)	(21,394)	(24,325)	(29,649)
Selling and marketing expenses	(2,993)	(5,695)	(7,614)	(9,009)	(11,105)
General and administrative expenses	(7,765)	(9,988)	(13,781)	(15,316)	(18,545)
Operating profit	14,644	17,880	27,835	34,862	42,919
Associate and jointly controlled entity	(81)	171	(100)	-	440
Finance income, net	488	1,230	401	1,057	2,061
Profit before tax	15,051	19,281	28,136	35,919	45,421
Tax	(2,266)	(3,718)	(4,361)	(5,567)	(7,040)
Minority interests	(53)	(61)	10	-	-
Net profit	12,732	15,502	23,785	30,351	38,380
Net profit (excl other gains)	13,016	14,598	21,285	30,001	38,030
EBITDA (RMB mn)	17,264	21,470	32,651	40,169	48,514
EPS (RMB)	1.393	1.692	2.577	3.239	4.092
DPS (HK\$)	0.200	0.240	0.357	0.449	0.567

Balance sheet (Consolidated)					
Year to 31 Dec (RMB mn)	2012	2013	2014F	2015F	2016F
Total assets	75,256	107,235	157,349	192,830	239,500
Current assets	36,509	53,686	65,480	94,406	131,871
Cash	29,709	43,982	53,298	79,991	114,104
Accounts receivable	2,354	2,955	3,807	4,505	5,552
Inventories	-	-	-	-	-
Other current assets	4,446	6,749	8,375	9,910	12,215
Non-current assets	38,747	53,549	91,869	98,424	107,629
Net PPE	8,731	11,605	12,789	13,482	13,887
Intangible assets	4,719	4,103	4,103	4,103	4,103
Investment properties	22	-	-	-	-
Interest in an associate	7,346	12,170	43,000	43,000	43,000
Other non-current assets	17,929	25,671	31,978	37,839	46,639
Total liabilities	33,108	48,772	76,856	84,602	96,230
Current liabilities	20,665	33,267	42,668	49,647	60,123
Trade payable	4,212	6,680	8,375	9,910	12,215
Other payable	6,301	10,246	12,563	14,865	18,323
Short term debt	1,077	2,589	4,600	4,600	4,600
Other current liabilities	9,075	13,752	17,131	20,271	24,985
Non-current liabilities	12,443	15,505	34,188	34,955	36,108
Long term debt	9,622	12,464	30,000	30,000	30,000
Other non-current liabilities	2,820	3,041	4,188	4,955	6,108
Total equities	42,148	58,463	80,493	108,228	143,270
Shareholders' equity	41,298	57,945	81,730	109,465	144,507
Share capital	2,880	2,846	2,846	2,846	2,846
Reserves	38,417	55,099	76,267	103,280	137,439
Proposed dividend	-	-	2,616	3,339	4,222
Minority interests	851	518	(1,237)	(1,237)	(1,237)
Total liabilities and equities	75,256	107,235	157,349	192,830	239,500
Net cash/(debt)	17,267	28,477	19,110	45,036	77,997
Working capital	(12,788)	(20,974)	(25,887)	(30,632)	(37,756)
Shareholders' equity+minorities	42,148	58,463	80,493	108,228	143,270
Net gearing (%)	NC	NC	NC	NC	NC

Cash flow (Consolidated)					
Year to 31 Dec (RMB mn)	2012	2013	2014F	2015F	2016F
Operating cash flow	18,753	26,109	33,103	39,347	49,038
Profit before taxation	15,051	19,281	28,136	35,919	45,421
Depreciation and Amt.	2,620	3,590	4,816	5,307	5,595
Change in Working capital	3,837	8,186	4,913	4,745	7,124
Interest received	(488)	(1,230)	(401)	(1,057)	(2,061)
Tax paid	(2,266)	(3,718)	(4,361)	(5,567)	(7,040)
Others	-	-	-	-	-
Investment cash flow	(19,384)	(17,335)	(41,589)	(10,037)	(11,587)
Capex	(5,076)	(6,464)	(6,000)	(6,000)	(6,000)
Interest income	488	1,230	401	1,057	2,061
Others	(14,796)	(12,101)	(35,990)	(5,094)	(7,648)
Free cash flow	13,677	19,645	27,103	33,347	43,038
Financing cash flow	(931)	5,499	17,802	(2,616)	(3,339)
Change in Debt	(1,033)	4,353	19,547	-	-
Dividend paid	(1,486)	(1,745)	(1,745)	(2,616)	(3,339)
Capital raised	1,588	2,890	-	-	-
Net cash flow	(1,562)	14,272	9,316	26,694	34,113

Key ratios					
Year to 31 Dec	2012	2013	2014F	2015F	2016F
Growth (%)					
Turnover	54.0	37.7	26.0	18.3	23.3
EBIT	24.3	22.1	55.7	25.2	23.1
EBITDA	25.8	24.4	52.1	23.0	20.8
Pre-tax profit	24.4	28.1	45.9	27.7	26.5
Net profit	24.8	21.8	53.4	27.6	26.5
Net profit (excl other gains)	33.1	12.2	45.8	41.0	26.8
EPS	24.2	21.5	52.3	25.7	26.3
Margins (%)					
Gross	58.5	54.0	61.4	65.3	65.0
EBIT	33.4	29.6	36.6	38.7	38.7
EBITDA	39.3	35.5	42.9	44.6	43.7
PBT	34.3	31.9	37.0	39.9	40.9
Net profit	29.0	25.6	31.2	33.7	34.6
Net profit (excl other gains)	29.7	24.2	28.0	33.3	34.2
Others (%)					
Effective tax rate	15.1	19.3	15.5	15.5	15.5
Payout ratio	11.7	11.3	11.0	11.0	11.0
Average RoE	36.5	31.2	34.1	31.7	30.2
Average RoA	19.3	17.0	18.0	17.3	17.8
Interest cover (x)	N.A.	N.A.	N.A.	N.A.	N.A.

Key assumptions					
Year to 31 Dec	2012	2013	2014F	2015F	2016F
Segmental revenue growth (%)					
Online game	N.A.	34.0	37.6	22.0	18.0
Social network	N.A.	9.0	37.5	26.0	22.0
Online advertising	69.8	48.8	50.0	43.0	43.0
Others	92.1	70.2	252.1	40.0	55.0

Sources: company data and Core Pacific – Yamaichi estimates
 From FY13F, Tencent will change its segmental reporting. MVAS (Mobile value added services) will be decomposed into gaming and non-gaming revenue and will merge with the online game and social network (formerly called Internet community) segment under previous reporting.

Definitions of Recommendations:

For stock recommendations:

- Buy: +15% or above of expected return over the next 12 months.
 Hold: Between +15% and -5% of expected return over the next 12 months.
 Sell: Potential downside of more than 5% over the next 12 months.

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